



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
HAROLD S. SANDLER)

For Appellant: Robert Baron
Attorney at Law

For Respondent: Philip M. Farley
Counsel

O P I N I O N

This appeal is made pursuant to section 18646 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the petition of Harold S. **Sandler** for reassessment of a jeopardy assessment of personal income tax in the amount of \$9,387 for the period January 1, 1981, through May 22, 1981.

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The issues are whether appellant received unreported income from illegal sales of narcotics and, if he did, whether respondent properly reconstructed the amount of that income'.

Appellant, during the period in question, was employed as a deliveryman and self-employed as a musician. At some time during the week of May 17-23, 1981, Detective Edward A. Freeman of the Los Angeles Police Department received information from an informant that a Harry Sandler was selling cocaine from his residence at 2420 1/2 North Beachwood Drive in Hollywood, California. -'The informant stated that while within the residence he had seen appellant sell to several persons small paper bindles containing a white powdery substance resembling cocaine. The informant further stated that within the last week he had purchased a half gram of cocaine from appellant for \$60. The informant said that appellant had resided at the Hollywood residence for approximately one year and had been selling cocaine from that location on a continuing basis during that year. The informant related that a month prior he had observed appellant in possession of a clear bag full of a white powdery substance resembling cocaine, Appellant weighed it into gram quantities on a triple beam scale and placed it into paper bindles.

Detective Freeman asked the informant to call appellant and discuss making a purchase, The informant dialed a number, later determined to be listed to appellant, and Detective Freeman listened on an extension to the following conversation:

Male Voice: Hello,
Informant: Harry.
Male Voice: Yeah.
Informant: This is (name deleted). I got my end together.
Male Voice: Great.
Informant: I'm wanting to get 1/8.^{1/}
Male Voice: It's got to be cash and it's \$300 for 1/8. I've got it here.
Informant: O.K., I'll get back with you.
Male Voice: Great!

Detective Freeman obtained a search warrant and on May 22, 1981, a raid was made of appellant's residence.

^{1/} Experienced narcotics officers interpret "1/8" used in this context to mean one-eighth ounce of cocaine.

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The police officers approached appellant's residence and saw him through the open door. They identified themselves, presented the search warrant, and informed appellant that they would be searching for cocaine. Appellant replied, "I only have a little in my dresser drawer for my personal use. I'm in the music business, you know how it is." The officers found 20 paper bindles containing cocaine in appellant's bedroom, 9 bindles in a box on top of his dresser, and 11 bindles in a leather pouch in the bottom of a vinyl suit bag in the closet. They also found a cocaine grinder which contained 0.4 grams of cocaine. In all, the officers found one ounce of cocaine which was worth approximately \$2,400 if sold in one-eighth to one-ounce quantities. iden-

Also seized at appellant's home were:

1. \$20,000 in cash.
2. Marijuana.
3. A bank passbook from Los Angeles Federal Savings which showed a balance of \$1,500.
4. An OHAUS triple beam balance gram scale.
5. Another gram scale.
6. A Pelouze brand scale.
7. A cocaine sifter,
8. A black vinyl pouch containing a portable scale,
9. A plastic baggie containing "sno seal" blank bindles commonly used by dealers for packaging cocaine for sale.
10. Two coke spoons.
11. One mortar,
12. Sheets of figures interpreted by police to contain records of narcotics sales transactions for the period of April 1980 through December 1980.
13. Two funnels,

Appellant was arrested and on the same day respondent was notified of the preceding events.

Based on the above information, which was obtained from the police reports, respondent determined that appellant's cocaine sales had resulted in taxable income for the taxable year 1980 and the taxable period January 1, 1981, through May 22, 1981. It was further determined that the collection of tax would be jeopardized in whole or in part by delay. Respondent estimated appellant's taxable income to be \$146,250 for the 1980 tax year and \$75,000 for the shorter 1981 period.

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Respondent allowed a 50-percent cost of goods sold deduction. Jeopardy assessments were therefore issued on May 22, 1981, for each of the above taxable periods reflecting a net tax liability of **\$17,227.34** for the 1980 tax year (assessment number: 02051400) and \$7,064 for the shorter 1981 period (assessment number 02051401). Two "Orders to Withhold" were issued for the two taxable periods totaling **\$24,291.34**. They were thereafter served on the Los Angeles Police Department and Los Angeles Federal Savings. Respondent received \$20,000 from the Los Angeles Police and **\$1,543.08** from Los Angeles Federal Savings in response thereto,

On May 28, 1981, with the assistance of the Los Angeles Police Department, one of respondent's compliance representatives personally conducted a telephone interview with the police informant. The informant told him that he had purchased three to four grams of cocaine per week from the appellant for the past two months. During this time, he observed the appellant selling to other buyers. The informant further stated his girl friend had been purchasing cocaine from the appellant for one year, and he knew the appellant presently supplied about one hundred people in the recording studios, selling them one to four grams each per week.

The determination of taxable income was originally reached by calculating the appellant's cocaine sales of three ounces a week at \$2,500 per ounce. The three-ounce estimate was a conservative calculation based upon information received directly from the informant.

On July 7, 1981, appellant's attorney, Robert Baron, filed a petition for reassessment with respondent. On July 24, 1981, appellant's attorney was advised that the petition for reassessment had been accepted and that it would be necessary for appellant to furnish information. Respondent sent a financial statement and questionnaire so that appellant could make a full and complete financial disclosure, including income from sales of controlled substances.

On December 28, 1981, respondent received appellant's Statement of Financial Condition and Financial Questionnaire dated and signed on August 19, 1981. Appellant claimed to have earned only \$1,200 from employment for the year 1981 to date while claiming \$700 per month living expenses. Appellant further reported \$1,500 in a savings account, and only \$2,200 in income for each of the years 1979 and 1980. No disclosure was made of

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appellant's income from the sale of narcotics. The appellant alleged the \$20,000 in cash seized during the raid was, in fact, money borrowed from various persons, although no notes or other evidence of any loans were found when the home was searched by the police.

On February 18, 1982, the appellant pled guilty to a violation of section 11351 of the Health and Safety Code, which concerns possession of cocaine for sale.

On July 26, 1982, respondent held a hearing on appellant's petition for reassessment, and on September 27, 1982, a further hearing was held. As a result, on October 26, 1982, respondent abated the jeopardy assessment for 1980 (number 02051400) and indicated that the 1981 jeopardy assessment (number 02051401) would be revised. Respondent's revision was based upon the following figures:

| | |
|--------------------------------------|---------------|
| Amount of cocaine seized | 20 bindles |
| Average weight | <u>1</u> gram |
| Total weight less packaging | 20 grams |
| Sales price of 1 gram of cocaine | \$100 |
| Total value of cocaine ^{2/} | \$2,000 |

Sales to the Informant

| | |
|---|--------------|
| Informant's purchase of grams of cocaine per week | 4 |
| Number of weeks cocaine was purchased | 8 |
| Total grams of cocaine purchased | 32 |
| Sales price per gram | <u>\$100</u> |
| Total sales price of cocaine sold to informant | \$3,200 |

"Other" Sales

| | |
|---|--------------|
| Informant's weekly estimated number of buyers of cocaine from appellant | 100 |
| Average grams of cocaine sold per customer | <u>2</u> |
| Total grams of cocaine sold per week | 200 |
| Sales price per gram | <u>\$100</u> |
| Total gross sales per week ^{3/} | \$20,000 |

2/ The value originally used was \$2,500.

3/ This amount correlates with the amount of money seized at the time of appellant's arrest.

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| | |
|--|-----------|
| Number of weeks of operation observed by informant | 8 |
| Estimated total gross sales of cocaine from March 22 through May 22, 1981 | \$160,000 |

No sales were attributed to appellant for the first 12 weeks of 1981 as the informant did not observe appellant's actions during that time.

On November 24, 1982, a revised jeopardy assessment (number 02059212) was issued which incorporated the above-discussed figures and the provisions of Revenue and Taxation Code section 17297.5, which effectively eliminated the deduction for cost of goods sold previously allowed. This revised income amount (\$85,000), when combined with the \$1,531 which appellant declared on his Form 540 and the \$75,000 as determined by respondent originally in assessment number 02051401, made the total taxable income for appellant \$161,531. The net tax liability of both assessment number 02059212 and number 02051401 was \$16,483. There is no evidence that the liability under assessment number 02051401 was appealed. That liability (\$7,096) became final thirty days after respondent notified appellant on October 26, 1982, of its action. (Rev. & Tax. Code, § 18645.)

On or about November 16, 1982, a refund was issued to the appellant for \$2,736 over and above the combination of the totals of the two assessments. On April 20, 1983, four more refunds were issued to appellant which totaled \$2,467.08.

Between December 7, 1982, and January 13, 1983, respondent received eight third-party claims from various persons containing statements that they had supposedly in the past lent the appellant differing sums of money.

On March 22, 1983, a further reassessment hearing was held in Los Angeles wherein appellant disagreed with the application of section 17297.5 of the Revenue and Taxation Code as it related to the appellant's assessment. No additional information was offered. On July 15, 1983, jeopardy assessment number 02059212 was affirmed.

The initial question presented by this appeal is whether appellant earned any **income** from the illegal sale of cocaine during the period at issue. The reports submitted by Detective Freeman, the results of the search of appellant's **house**, and the statements from the

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informant establish at least a prima facie case that appellant received unreported income from the sale of cocaine during the appeal period. As appellant has presented no evidence to refute this prima facie showing, we must conclude that he did receive unreported income from the sale of illegal drugs during the appeal period.

The second issue is whether respondent properly reconstructed the amount of appellant's taxable income from cocaine sales. Under the California Personal Income Tax Law, a taxpayer is required to specifically state the items of his gross income during the taxable year. (Rev. & Tax. Code, § 18401.) As in the federal income tax law, gross income is defined to include "all income from whatever source derived," unless otherwise provided in the law. (Rev. & Tax. Code, § 17071; Int. Rev. Code of 1954, § 61.) Gain from the illegal sale of narcotics constitutes gross income, (Farina v. McMahon, 2 Am. Fed. Tax R.2d 5918 (1958).)

Each taxpayer is required to maintain such accounting records as will enable him to file an accurate return. (Treas. Reg. § 1.446-1(a)(4); former Cal. Admin. Code, tit. 18, reg. 17561, subd. (a)(4), repealer filed June 25, 1981 (Register 81, No. 26).) In the absence of such records, the taxing agency is authorized to compute a taxpayer's income by whatever method will, in its judgment, clearly reflect income, (Rev. & Tax. Code, § 17561, subd. (b).) The existence of unreported income may be demonstrated by any practical method of proof that is available in the circumstances of the particular situation. (Davis v. United States, 226 F.2d 331, 336 (6th Cir. 1955); Appeal of Carl E. Adams, Cal. St. Bd. of Equal., March 1, 1983.) Mathematical exactness is not required. (Harold E. Harbin, 40 T.C. 373, 377 (1963).) Furthermore, a reasonable reconstruction of income is presumed correct, and the taxpayer bears the burden of proving it erroneous. (Breland v. United States, 323 F.2d 492, 496 (5th Cir. 1963); Appeal of Marcel C. Robles, Cal. St. Bd. of Equal., June 28, 1979.)

In view of the inherent difficulties in obtaining evidence in cases involving illegal activities, the courts and this board have recognized that the use of some assumptions must be allowed in cases of this sort. (See, e.g., Shades Ridge Holding Co., Inc., ¶ 64,275 P-H Memo. T.C. (1964), affd. sub nom., Fiorella v. Commissioner, 361 F.2d 326 (5th Cir. 1966); Appeal of David Leon Rose, Cal. St. Bd. of Equal., March 8, 1976.) It has also been recognized that a dilemma confronts the

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taxpayer whose income has been reconstructed. Since the taxpayer bears the burden of proving that the reconstruction is erroneous' the taxpayer is put in the position of having to prove that he did not receive the income so attributed. In order to ensure that the taxing authority's reconstruction does not lead to injustice by forcing the taxpayer to pay tax on income he did not receive, the courts and this board have held that each assumption involved in the reconstruction must be based on fact rather than on conjecture. (Lucia v. United States, 474 F.2d 565, 574 (5th Cir. 1973); Shapiro v. Secretary of State, 499 F.2d 527, 533 (D.C. Cir. 1974), affd. sub nom., Commissioner v. Shapiro, 424 U.S. 614 [47 L.Ed.2d 278] (1976); Appeal of Burr McFarland Lyons, Cal. St. Bd. of Equal. Dec. 15, 1976.) Stated another way, there must be credible evidence in the record which, if accepted as true, would "induce a reasonable belief" that the amount of tax assessed against the taxpayer is due and owing. (United States v. Bonaguro, 294 F.Supp. 750, 753 (E.D.N.Y. 1968), affd. sub nom., United States v. Dono, 428 F.2d 204 (2d Cir. 1970).) If such evidence is not forthcoming, the assessment is arbitrary and must be reversed or modified- Appeal of Burr McFarland Lyons, supra.) In essence' appellant challenges the jeopardy assessments as being arbitrary.

In the instant appeal, respondent has used what is known as the projection method in reconstructing appellant's income from the illegal sales of cocaine. Respondent first determined appellant's income for a base period and then projected this figure over the entire two-month period of sales activity to yield appellant's total income. The data relied upon by respondent in reconstructing appellant's income was derived from information contained in the Los Angeles Police Department's arrest report, the items found as a result of a search of appellant's home, and statements from an informant. On this information, respondent determined that appellant:

- (1) sold cocaine from March 22, 1981, through May 22, 1981, from which he derived unreported taxable income:
- (2) sold cocaine to 100 persons per week with the average amount sold being 2 grams;
- (3) sold the cocaine for \$100 per gram; and
- (4) realized a gross income of \$20,000 a week from such sales.

Respondent first determined that appellant had been selling cocaine from March 22, 1981, through May 22, 1981. The record reveals Edward Freeman of the Los Angeles Police Department met with an untested confidential informant and was informed that appellant was

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selling cocaine from his residence. The informant personally observed appellant sell small paper bindles containing a white powdery substance resembling cocaine to several persons. The informant personally, over the two-month period, purchased cocaine from appellant paying \$60 for one-half gram. Detective Freeman also listened in on a telephone conversation between appellant and the informant which caused Detective Freeman to conclude that appellant was **selling** narcotics. A search of appellant's home revealed various items such as a triple beam "OHAUS" scale, a grinder, a cocaine sifter, a Pelouze brand scale, a portable scale, and a plastic baggie containing "sno seal" blank bindles all of which indicate a business of trafficking in cocaine. Appellant at the time of the search, also had \$20,000 in cash in his home. One of respondent's compliance representatives spoke with the informant on May 27, 1981, and was told that the informant had been purchasing three or four grams of cocaine a week from Sandler during the last two months. We must conclude that respondent's first finding is supported by the record and that it is reasonable to conclude that appellant was trafficking in cocaine for the two-month period. Information from an untested confidential informant will be considered reliable if the information that he supplies proves to be accurate and ultimately results in the seizure of narcotics and appellant's arrest and subsequent conviction, (Appeal of Clarence Lewis Randle, Jr., Cal. St. Bd. of Equal., Dec. 7, 1982.) The search of appellant's home did result in the seizure of narcotics, and appellant did plead guilty on February 18, 1982, to a charge of possessing cocaine for sale.

The assumption that appellant sold cocaine to 100 persons a week with the average amount sold being two grams is also supported by the record. The informant in his telephone conversation of May 27, 1981, with respondent's compliance representative stated that appellant supplied up to 100 people who worked in the local recording studios and that each would buy from one to four grams or more a week. The estimate of two grams a week per customer is a reasonable average sale. The informant stated that he personally had purchased three to four grams a week for the last two months. Appellant was also in possession of \$20,000 in cash, which is approximately the amount of income that would be derived from one week's sales to the number of persons the informant indicated appellant supplied (100 persons buying two grams a week at \$100 per gram),

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The assumption that appellant sold the cocaine for \$100 a gram is likewise supported by the record. Statements from the informer indicate that he paid \$60 per one-half gram and information from the State of California Department of Justice Advanced Training Center shows that the cost of a gram of cocaine in the Los Angeles area ranges from \$70 to \$120. The \$100 per gram figure is slightly less than the average of these figures and is, therefore, reasonable.

We note that in its original assessment, respondent allowed appellant a 50-percent cost of goods sold deduction but eliminated the deduction in its revised assessment. While in previous cases respondent has allowed taxpayers engaged in the illegal sale of controlled substances to deduct the cost of goods sold from gross sales to arrive at their taxable income, this type of deduction is now statutorily prohibited by Revenue and Taxation Code section 17297.5, which provides, in pertinent part, that:

(a) In computing taxable income, no deductions (including deductions for cost of goods sold) shall be allowed to any taxpayer on any of his or her gross income directly derived from illegal activities as defined in Chapter 4 (commencing with Section 211) of Title 8 of, Chapter 8 (commencing with Section 314) of Title 9 of, or Chapter 2 (commencing with Section 459), Chapter 4 (commencing with Section 484), or Chapter 5 (commencing with Section 503) of Title 13 of, Part 1 of the Penal Code, or as defined in Chapter 6 (commencing with Section 11350) of Division 10 of the Health and Safety Code; nor shall any deductions be allowed to any taxpayer on any of his or her gross income derived from any other activities which directly tend to promote or to further, or are directly connected or associated with, those illegal activities.

* * *

(c) This section shall be applied with respect to taxable years which have not been closed by a statute of limitations, res judicata, or otherwise.

The sale of controlled substances, including cocaine, constitutes an illegal activity as defined by chapter 6 of division 10 of the Health and Safety Code.

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(Health & Saf. Code, § 11350 et. seq.) Accordingly, no deduction of appellant's cost of goods sold is allowable.

In sum, we must conclude that respondent's projection of income of \$20,000 a week or \$160,000 for the two-month period is reasonable. This figure is computed by assuming that appellant sold 200 grams of cocaine a week for \$100 a gram for only the two-month period during which the informant personally made purchases from appellant and was aware of appellant's sales activities. This reconstruction of appellant's income has a foundation in fact and is not arbitrary or unreasonable.

The conclusion that the reconstruction is reasonable does not **end our** inquiry. Appellant may still prevail if he can prove, by a preponderance of the evidence, that the **modified** assessment is erroneous. (Appeal of Peter O. and Sharon J. Stohrer, 'Cal. St. Bd. of Equal.', Dec. 15, 1976.) The phrase "preponderance of the evidence" means "**such evidence as**, when weighed with that opposed to it, has more convincing force, and from which it results that the greater probability of truth lies therein." (In re Corey, 230 Cal.App.2d 813, 823 [41 Cal.Rptr. 379] (1964).)

In an attempt to meet this burden, appellant contends that the \$20,000 seized from him by the police when they searched his home was only "loans" from individuals who wanted to invest in a musical show. Appellant alleges that the ten purported promissory notes prove this contention. We cannot agree for several reasons. First, when the police searched appellant's home none of the notes were found by them or produced by appellant. Secondly, none of the notes were notarized and many of them indicate that the money was lent to cover living **expenses**. While the funds were allegedly advanced as early as April of 1980, over a year before the money was seized on May 22, 1981, appellant has not stated why none of the funds had been spent for living expenses **or** other purposes. Thirdly, appellant did not allege that the money was from loans until he filed his statement of financial condition, which was not done until December 28, 1981. Finally, the money does not appear to have been earned by appellant from his employment as a musician, as appellant claimed to have earned only \$1,200 from employment for the year 1981. Appellant's living expenses **were \$700** a month, which far exceeds his claimed income. A consideration of all the evidence submitted leads us to conclude that appellant has not shown by a preponderance of the evidence that the

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assessments made by respondent were erroneous. Accord-
ingly, respondent's action in this matter will be
sustained.

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O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the petition of Harold S. Sandler for reassessment of a jeopardy assessment of personal income tax in the amount of \$9,387 for the period January 1, 1981, through May 22, 1981, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day of October , 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis, Mr. Bennett and Mr. Harvey present.

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|----------------------------------|------------|
| <u>Richard Nevins</u> | , Chairman |
| <u>Ernest J. Dronenburg, Jr.</u> | , Member |
| <u>Conway H. Collis</u> | , Member |
| <u>William M. Bennett</u> | , Member |
| <u>Walter Harvey*</u> | , Member |

*For Kenneth Cory, per Government Code section 7.9